What really is a pricing strategy?

Personal reflections by

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Every company has a pricing strategy. It may be simple like adding a fixed margin to the cost. It may be pricing based on a competitor's price list. Or, it may be something more elaborate.

Simple pricing strategies have advantages. They are easy to understand, they are easy to implement and it does not take a lot of company resources to develop, maintain and communicate them. But they also have some serious flaws; they reduce the company's sales level, they leave money on the table, they accelerate commoditization. Overall they decrease a company's ability to compete and grow. In short, companies with simple pricing strategies are never the market leaders; they are nearly always the underdogs. They always struggle, never having enough resources for sales, marketing and product/service development. Never having enough resources to innovate. They struggle with profitability.

In fact, price-savvy companies are usually the market leaders. They are the companies others aspire to become, the companies who earn the most money and grow the fastest. They are the companies with resources to innovate. And those are the companies that generate the highest shareholder value.

So if there is a better way to price, what does it look like?

These price-savvy companies use more a more sophisticated pricing strategy. An optimized pricing strategy. Taste this word: *optimized*. What does it really mean? My dictionary says it means to "make the best or most effective use of (a situation, opportunity, or resource)". In the context of pricing, this is what it means: The price of your product or your service provides you the opportunity to capture a portion of your customers' willingness to pay. When your pricing strategy is optimized, you make the best use of that opportunity - <u>you are capturing the maximum possible of that willingness to pay</u>.

An optimized pricing strategy is built around a pricing structure that supports various pricing actions and strategies, it has optimized pricing levels, it has discounting polices that specifically support the company's strategic goals, it guides the company to the portion of the addressable market with a higher willingness to pay, and it influences sales compensation and sales training. Let's look at each of these variables in more detail.

Pricing structure:

The pricing structure is key to an optimized pricing strategy. As an optimized pricing strategy is built on various tactics and strategies that increase customers' willingness to buy and willingness to pay. Unless the pricing structure supports these actions, companies simply cannot do these, and therefore cannot use price to influence willingness to buy and willingness to pay. They end up leaving the customer in control of the company's pricing.

Good-Better-Best:
For just about any item in the price list having a good-better-best offering allows a company to capture buyers with different needs and different willingness-to-pay levels. It simplifies sales and enables a salesperson to direct a customer to "lower" level of offering instead of giving a discount.

But the good-better-best structure has other benefits too. There are always customers who want "the best," and they can be served here with the "best" offering. And also, the way price imaging works (see below for more details) is to frame the "better" offering to appear more affordable.

Bundles and unbundles:
Another key element of the pricing structure is bundles and unbundles. In fact, in some cases the good-better-best strategy is just that, different bundles of the same offering. The importance of unbundles is, just like with the good-better-best strategy, these unbundles allow a salesperson to offer a unbundled offering instead of giving a discount. So what is an un-bundle? Almost everything we buy is a bundle of some sort. Your BluRay player came with a remote control, a few disks and maybe several cables bundled in. A professional level network switch comes with power cable, installation software, rack-mount ears and maybe 3 years warranty. Un-bundling splits these apart, and prices separate components separately. Now, in the BluRay example, un-bundling may not be possible as consumers expect it to be delivered "complete", but in second example you can. Imagine the salesperson saying "Yes, Mr. Customer, we can meet your price for the new switch, but then we cannot supply the power cable and you have to use your existing cable" as opposed to the same salesperson saying "Yes, Mr. Customer, we will give you another 8% discount". But stop and think about this for a second. Unless the pricing structure supports this unbundling, where there is a line items for the device with and without the cable, the salesperson has no choice but to give the requested discount - and this, of course, affects the company's profitability. But also, this sets a long-term precedent for continued discounting to close every deal.

Price imaging:

Another key element of a pricing strategy is price imaging. We, as humans, look at different offerings and unconsciously compare them. Price imaging takes advantage of this fact. An effective way to increase the willingness to buy and to pay for a product or a service is to offer something substantially higher in price than the product you really want to sell, in the same category. As the buyer compares the two prices, the less-pricey alternative becomes, in their mind, more affordable and has greater price-value. Let me give you a couple of examples: After browsing the $4,000 handbags a the Prada store, the $600 wallet at the checkout counter looks like a bargain; Apple offers a laptop with a 17-inch screen and all the bells and whistles for $2,499 that makes the regular laptop with a 15-inch screen at $1,799 looks affordable in comparison (prices as of June 2011). Apple sells almost none of the 17 inch version, and a lot of the 15-inch version.

A high-priced offering has another, longer-term effect. Items we buy often have a reference price. We "know" what a product or a service "should" cost. Above that reference price, willingness-to- buy and -pay decrease rapidly and substantially. By providing an offering at a substantially higher price, with unique features or functions, over time, it is possible to educate the buyers to the fact that the reference price is higher than they originally thought. This is a process that may take a few years, but the sooner you start, the sooner you will reap the benefits. Let's give an example. For years and years, the Big 3 auto makes had a problem that a "4-door family car" (eg Fort Taurus) had a reference price of $18,000. As soon as they started to price above that, the sales level dropped and discounting increased. The problem was that for a retail price of $18,000 the manufactures could not build a quality product and, as we know, for many years in the 80s and 90s, the quality of these products was inferior. The solution was to offer high performance versions of these very pedestrian cars at substantially higher prices, and over time, this diminished the reference price problem. Buyers came to accept that a satisfactory car would cost them more than $18,000. The reference price moved up. Now (June 2011) four-door family car is around $26,000 with high performance versions of the same car priced at fully $10,000 more, at $36,000.

Price imaging also works from the other side. By offering something really cheap, but with very limited functions and features, the relative value of what you really want to sell is increased, and so is willingness to buy and pay. But of course, this needs to be done in consideration of the marketplace and competition.

Options

Options are also part of the price structure. They provide important opportunities for up-selling. Once your customer made a decision to buy your main product or service, he or she is already in "buying mode" and it is relatively easy to continue to add options, many times simply because options may add a level of convenience that, at the time, add considerable value to the buyer. Many on-line retailers excel in this. Computers are offered with the options of pre-installed software, added memory, extended warranty and faster shipping. On-line book and CD stores offer "people who bought what you did, also bought this or that".

Differentiated price structure:

If what you are selling is highly commoditized and there is a plethora of competitors with very similar products or services, one way to differentiate the offering is to price it differently. Introduce another variable into your price levels. This is makes it difficult or even impossible for a potential buyer to compare two offerings on price alone. Whatever (small) differentiator your offering has becomes more noticeable and you will be able to capture a portion of the market that prefers just your pricing structure. But even with a differentiated pricing structure, the price needs to make sense to the buyer. Let me give you an example: One company was selling a service for on-line training and education, and it had a number of competitors with very similar services. All the competitors were pricing in tiers, based on the number of registered viewers. So the buyer could select to have up to 50, up to 200 etc registered viewer. It was very easy for buyers to compare prices of competitors and simply select the cheapest. It became a race to the bottom. But this company was smarter. They priced not on the number of registered viewers, but on on-line sessions actually delivered. Just the pricing structure made the company different and with a differentiated offering, they had pricing power. They did not have to participate in the race to the bottom. And the pricing structure also made sense to the buyer.

Clarity:

Despite all of this, the good-better-best, bundles and un-bundles, the price imaging, the options and a "different" price structure, the price structure also needs clarity. Some companies come up with elaborate and complicated price lists because they say it "hides" the true price. The companies believe they can fool their customers, and realize higher prices without loss of sales volume. This is completely wrong thinking. A price list that generates confusion in your customers' minds has the opposite effect. A confused prospect rarely make the buying decision in favor of the confuser. People simply want to know what they are buying, how much they are paying and, with clarity in their minds, make decisions. If a prospect has two near-equal choices, and one presents its price in such a way it generates confusion - the prospect will inevitably select the product or service with the price he or she understand

Optimized price levels

The price of your product or services is a value statement. In fact, it the strongest value statement you can make. VMWare, the strong market leader in something called server virtualization software (used in almost all data centers) continued to charge high prices for its flagship software product for years after Microsoft and Citrix began offering theirs for free. Recall the Prada story. It is the price itself that makes the value; the exclusivity of the brand is generated and maintained by the high price, and the high price is a strong indicator of quality and design of the product. Even if the manufacturing cost, including cost of exclusive raw materials, of a Prada handbag may be 3 - 5 - 10 times that of a "generic" non-branded handbag, it is still the price that make up most of the value it generates for its buyers. So how can I tie this into optimized price levels? Here is how: Of course there are people, many people, who can't afford a $4,000 handbag. At the same time, there are people who can afford it but believe the price is ridiculously high and others, not very many, I would guess, who think the price is not high enough, does not provide enough exclusivity and therefore value. And this is the trick with optimized pricing. At any given price you set, a number of prospective buyers will simply say they cannot afford it; a number of prospective buyers will say they just won't buy it, and, maybe surprisingly for some readers, some will say it is not high enough, does not message enough of a value and quality, so they won't buy for that reason.

Let me give you a real life example. My life. I was in Las Vegas for a convention and I needed a haircut. I was staying off the Vegas Strip, and as I drove in to the convention center I passed a strip-mall with a large sign: Men's Haircut $8. Did I stop? No. Later, another strip-mall and another sign: Men's Haircut $12. Did I stop? Still no. These prices were to me a message of inferior quality. Not that I'm particularly vain, but I simply would not trust someone cutting my hair for such a low price. I expected it to be something wrong with their hair-cutting skills when they sold their services so cheap. So instead I stopped at a strip-mall where there was no sign at all and got a $24 haircut. I paid what I expected to pay. Was my $24 haircut better than the $8 or the $12 one? I don't know - but I certainly did not want to find out!

Likewise, I have the Atenga website hosted at a reputable hosing provider and pay around $25 per month for. I know I could get hosting for $10 or even as low as $1/month, but I elect not to use these service providers - their much lower price is, again, for me a message of inferior quality. The website is critical to my business and I would not want to risk that with a low price hosting and where I expect low reliability. But of course this is just in my perception. The $1/month hosting may be just as good as the $25/month hosting I use now. But I don't want to take the risk to find out it is not.

So prices are optimized at the price point where the minimum of prospective buyers, say the price is either too high or too low, and they will not buy because of that, and, where the maximum of buyers say it is good value and meet their price expectations. They are further optimized when there are structures and sales processes that capture higher prices when buyers are willing to pay "more," and also win the business of buyers who would be profitable but are only willing to pay "less."

This is all about psychology of pricing. It's based on how we humans make buying decisions. And we are all different. But how do you find out what the optimized prices are? Well, there are many bad and one good way. Trial and error is one bad way. The good way are price-specific market research, and a buying-decision simulation method, called the Van Westendorp Price Sensitivity Meter.

Trial and error to set optimized prices

Imagine that you lower your prices. Several things may happen:

- As you lower the price within a “reasonable” bound your sales may increase but, depending on the price elasticity, your revenues may drop or they may increase.
- Or, your sales may stay flat, and with lower price for the same sales volume, your revenues will drop.
- Or, your sales may even drop, together with revenues. This could be because potential buyers will think your price is too low for the quality they expect and at one price-point your sales will start to drop.
- Or, if your current price is way too high, both your sales volume and revenues will increase

Likewise, as your increase the price

- As you increase the price within a “reasonable” bound your sales may decrease but, depending on your price elasticity, your revenues may drop, or they may increase.
- Or, your sales may stay flat, and with a higher price for the same sales volume, your revenues will increase.
- Or, if your current price is way too low, both your sales volume and revenues will increase

So using trial and error is a hit-or-miss proposition. It can work well if your business allows you to do this testing in a limited market; like a restaurant chain the can do this testing in for only a few restaurants and not the whole chain. But if that is not an option, trial and error is very likely to be costly in lost revenues and profits as the outer boundaries for the optimized pricing range are explored; on the low side because you then leave money on the table, and on the high side because sales level will drop. Trial and error works well when price and sales and/or revenues increases, but it requires a strong conviction to continue the experiment as sales level and/or revenues drop, and it is necessary to continue the experiment long enough to have valid data.
Trial and error also poses another issue - that of first maybe decreasing and then increasing prices. Not only is it more difficult (but not impossible) to increase prices, but ever changing-prices also confuse customers. And, as I established above, a confused customer doesn’t buy - at

Science to set optimized prices

The other way, using the Van Westendorp's Price Sensitivity Meter (PSM) is really better. It is disruptive, often quicker, and, in almost all cases, much cheaper, and more accurate than trial and error. Peter Van Westendorp was a behavioral economist at the University of Leiden in Holland. In 1972 he invented PSM. It is as simple as it is ingenious. By asking potential buyers in an anonymous survey four simple questions, then analyzing the frequency distribution of the answers it, is possible to assess the optimized price with great accuracy.

But the PSM is not without issues too. It can really only be used for products or services that can be described in relatively simple terms, but images and videos can help to describe more complex offerings.

But what about Conjoint Analysis, some readers may say? Well, Conjoint is great for cross-price elasticity studies, and as a validity check for the PSM, but it also typically overstate the importance of price as a decision driver.

Discounting:

Consider that the average company has resulting profits of around 10% of revenues, increasing overall discounting with a single percent, will reduce profitability about 10% as profits will drop to 9% of revenues. Increasing discounting with 5% will half the profits - and the company consequently need to double its sales volume to gain the same dollar profit!

It is this simple math that makes discounting, or the lack thereof, one of the most powerful profit makers (if it is controlled), and one of the most powerful profit zappers (if it is uncontrolled). It is why the un-bundling and good-better-best strategies above are so important. It is why the price structure must support un-bundling and good-better-best tactics. It is why the salespeople need these tools to close the deal without discounting.

Yet, why then does executive management consistently give the sales organization almost free range when it comes to discounting? Because "that's the way it has always been," because very few company execs stop and make the calculation I just did for their company. Unless the pricing structure supports un-bundling, price imaging and good-better-best tactics, there is no viable alternative. And now, dear reader, is your chance. Stop for a moment and make the calculation and consider your price structure. How much would an additional percent discount affect your profits? How about five percent? If you discount another 5%, how much do you have to increase your sales volume to return to the same dollar profit as before the additional discount? Does your price structure support un-bundling and does it have a good-better-best component?

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Often companies have a tiered discount allowance. Salespeople may be allowed to discount 10%, the regional manger 20% and the Sales VP 30%. What happens then is that a lot of the business will come in at the maximum of those allowances. There will be a flurry of orders at 10% discount, at 20% and fewer at 30%. Just because that is the maximum each of these tiers allow. So a very simple way to reduce discounting is simply to move these permissions. In this case changing them to 5% for salespeople, 10% for regional managers and 20% for the sales VP will have an enormous impact on your bottom line. Will they complain? Yes of course!

Some savvy companies simply eliminate discounting by prohibiting the sales people from doing it. But in order for that to be a success, the price structure must support un-bundling and a good-better-best tactic, and service options. And they must have the tools to manage price discussions and they need to be trained to use them. And you must be certain – more certain than most companies are – that your list prices are set to levels customers are willing to pay, with due respect to value drivers, purchase drivers, price drivers and competitive position. So it is quite involved - but the benefits will be very substantial.

Discounting has other drawbacks. Every time a company discounts, the value perceptions get a little knock. And if these discounts are continuous and are rampant, those become a much larger knock. The company, over time, becomes known for being willing to sell cheap, and gets a reputation for delivering low value to their clients. At that time, discounting and low value perceptions become a vicious circle, a downward pricing spiral Recovery takes time and flawless execution. The company has become commoditized. Whatever values they provide to are devalued by their customers, and they have begun to serve the portion of the market that buys primarily on low price, or highest discount

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Likewise, many companies' relentless focus on many-times-artificial quarterly and yearly goals simply means that customers wait to buy. They know that at the end of their suppliers' quarter and fiscal year, higher discounts will be offered. And while the company is always in a hurry to sell, the buyers are rarely in a hurry to buy. As a result buyers play the game to their benefit - at the company's loss.

A friend of mine, the CEO of an IT VAR, just yesterday told me this story: His company had long been a supplier to a manufacturing company L, whose name you would know. For years the IT VAR supplied L with IT hardware (computers, network components and so forth) and services under a master sales contract. This master contact spelled out conditions such as discounts and other terms. The VAR made good margins under this contract and could therefore afford to provide a superior service level to L. It was a win-win situation. Then one December one of VAR's hardware suppliers, also a company you would know, began pressing the VAR to close a large deal with L before the end of the year. The VAR refused, as they knew L would buy anyway in February, under that win-win sales contract. My friend even managed to get to the top management of his hardware supplier with his refusal, and was told "Next year does not exist. We need the business now". Then the hardware supplier circumvented the VAR and sold the large system to L, with 80% lower margins than the VAR had done. The result: The hardware supplier destroyed the VAR's win-win situation, they set a new reference discount and my friend the VAR could no longer afford to provide the support that L expected. In fact, L stopped doing business with the VAR completely. This was sad for the hardware supplier (who lost a good VAR), for L (who lost the support of the VAR) and for the VAR (who lost a good client). All because an artificial short-term revenue target was more important than profits or long-term relationships!

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But does this mean that discounting should never be used, under any circumstance? Not at all. Discounting is, as we all know, a powerful tool to close business. But even more important is that discounting be used to encourage profitable customer behavior. It is only when discounting is used, as it is by many companies, indiscriminately (habitually) it becomes the poison pill just described.

I recall a company selling enterprise software, whose CFO said: “Our salespeople discount our software 80%, and then they negotiate down from there”. Was this company the market leader in their field? No. Was it growing. No. Was it profitable. Just barely.

Different companies have different circumstances and different customer behaviors that could be encouraged by discounting. For example, companies may use discounting to drive customers to more profitable products or services, to strategic product or services from which there are up-sell or lock-in opportunities, to buy products already in stock, to select a longer delivery time, etc. The examples are legion. But the key takeaway here is that there has to be thought, a plan, a reason behind every instance of discounting. “The customer asked for it” is rarely a good enough reason. And it has to be targeted to a particular product or service - never should it be used indiscriminately!

You get what you price for

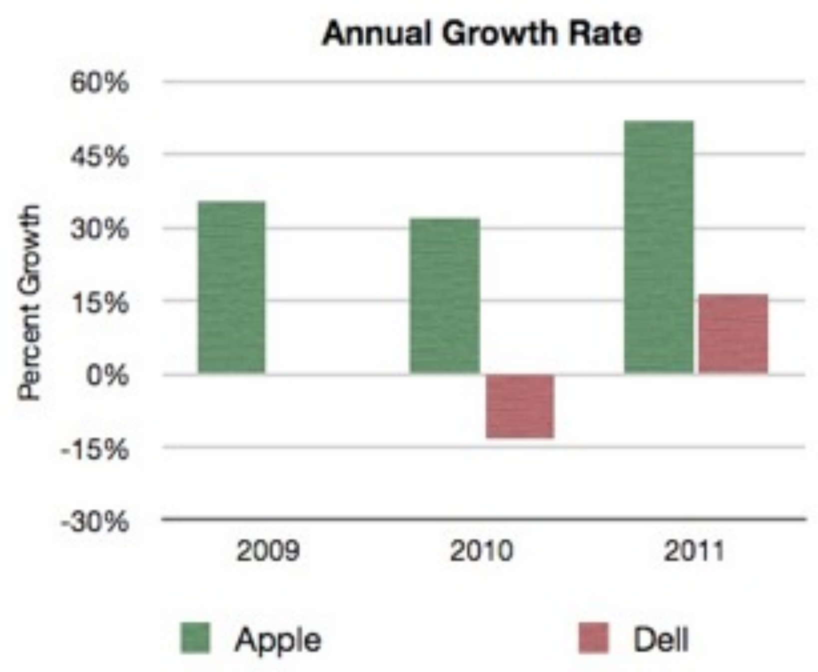
The price of a product or a service is the strongest message of that product's or service's quality. It sets the buyers' expectations of quality. So the price becomes either the driver for a company's business strategy or market position. The price needs to be set in full support of that business strategy or market position. Any discrepancy will alienate customers.

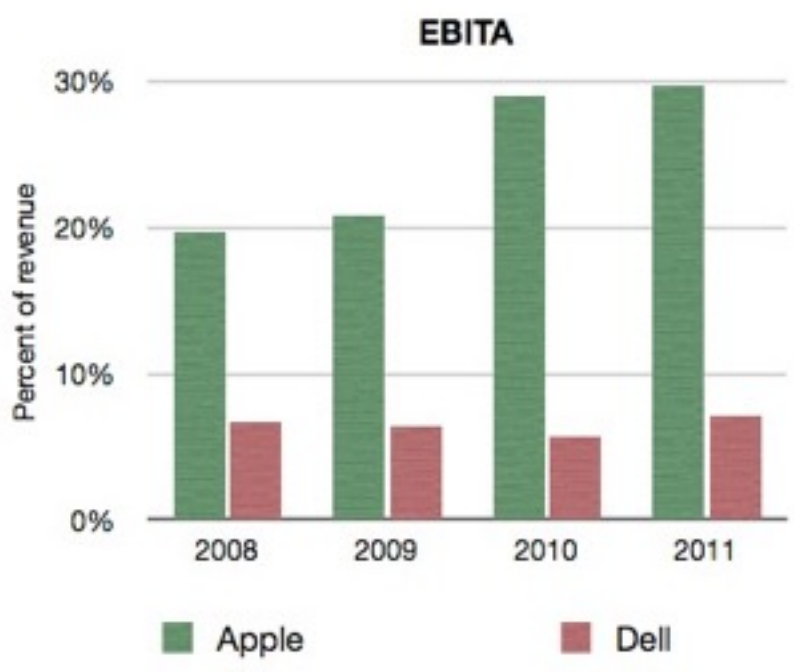
The importance of saying NO!

On the question of when Apple would bring out a $300 NetBook computer, Steve Jobs famously replied "Never. I just don't know how to make a quality product at that price". In that short sentence he summed up Appel's whole business strategy, positioning and price strategy. Apple makes quality products for customers who are willing to pay more, and they recognize that most buyers will not pay their price. In fact they have less than 10% of the PC marketplace, but they earn well over 50% of the profits for the entire industry. They simply elected to say no to buyers who buy product on price. They decided not to play in the low-price game. But in order to do that, they also have to provide their customers with something different. And they do. They don't use a commodity operating system, they make sure their products have a distinctive look, and they are priced much higher than competitors. The results speak for themselves; they are now (June 2011) the most valuable company on the stock market.

This position, this refusal to play in the low-price game has provided Apple with resources to innovate, producing the iPod and its eco system of iTunes, and the iPhone and the iPad.

One of my favorite comparisons is that of Apple and Dell. Apple's pricing strategy says NO to customers buying on price – Dell's says YES to everybody. The results are two vastly different companies and two vastly different business strategies giving rise to two vastly different financial performances. See next page





AsI just said, Dell and Apple have fundamentally different business strategies. Both have a core PC business plus an added value business. In Apple's case that is iTunes, iPod, iPhone and iPad. In Dell's case it is servers and storage for data centers and corporate IT department. Dell sits squarely in the commodity space; they sell same software as everybody else and hardware that is virtually identical to that of other PC vendors.

Thus, they serve the market where a low price becomes the most important decision factor.

And here is the lesson. Almost every company chooses its customers. It can join the race to the bottom, or it can distinguish itself in some way, and serve a market vertical willing to pay a higher price for more value.

Sales compensation

We all know that compensation drives behavior, and we also know from the discussion above that it is a company's margins that allow a company to innovate and to grow, and that indiscriminate discounting zaps a company's profits. So what do the vast majority of companies do? They send out their salespeople with a single message: "get the deal at any cost" and then they compensate them with commissions on the revenue they generate. The results? Rampant discounting; a flood of discount request to management; downward pricing pressure; sales of lower priced items; commoditization; loss of pricing power. Why is this?. Because it is "the way it's always been done". Straight revenue commission is simple. For the company and for the salespeople. But the results, many times, are devastating.

But as we know that compensation drives behavior, what kind of behavior would be better for the company? Well, a drive towards higher priced products, higher margin products and products that are strategic; that can support upselling, that defend market share, that fend off competitors.

This really means that sales compensation needs to be more elaborate and there need to be a lot more thought put into it. But at the same time, sales compensation need to be simple and understandable. The salespeople need to be able to think on their or his feet as they negotiate the deal that would be most beneficial for the company and the sales person at the same time. And some companies are reluctant to give salespeople information on cost; as they worry that, as salespeople change jobs, this information will travel to competitors. One solution is to grade the products or services in three or more colors. Like a traffic light. Red for product where commission is low, yellow where it is higher, and green where it is highest. Then salespeople do not have to know the cost of the product or service and they also do not have to know what products or services the company thinks are strategic. But there are other ways and every company has a different situation and circumstance, so this needs to be tailored to whatever that circumstance is.

Summary

So in this paper I have covered most, if not all, the aspects of what constitutes an optimized pricing strategy. Since you stayed with me all through the paper, you now know that pricing is more than just a number. It is process and structure. Its tentacles reach to almost every nook and cranny of your company; sales, product marketing, production, product management, finance, executives and maybe even to the board.

And I'm sure that if you see a mountain of things to do to get your company into optimized pricing, not only do you need it the most, but the sooner you start the better. And of course you'll start small. Maybe just take 10 or 20 of your products. Have your product management categorize these products into A - B - C - D categories. A for totally unique products, D for totally commodity products. B and C for in-between. Then for A products you simply stop all discounting. For B products you lower the allowed discount rate. You have your product management work on un-bundles for the A and B product. You may want to try to increase price for them, and increase sales commission too - but just for the A products. Devise a good-better-best strategy for these product. Introduce price imaging - maybe with bundles. You look at the D products with the view of "are they strategic?", "can we further reduce cost?" and "are we making enough money on these so it makes it all worth while?". If they are not strategic or you are not making enough money on them, ask yourself why you still want to sell them. If you decide to - what can you do to reduce cost?

As you follow the results of these 10 or maybe 20 products, I can guarantee that you'll be astonished of the results. It will add to your bottom line so that you gain more resources to continue the price optimization; categorize more products; generate more un-bundles and bundles; train your salespeople on selling without discounting; invest in research to discover buyers' true willingness to pay. Eventually you probably will need to recruit a person to run the pricing process in the company, and now you are really in price optimization happy-land and you realize that your revenue growth will double and your profits too - compared to when you started out.

Thanks for your time!

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